

Bridging the Gap

In the 1990s, the share of California's revenue base derived from the stock market and capital gains increased dramatically. In 2000-01, nearly 25 percent of California's General Fund revenues were generated by the stock options and capital gains, particularly from California's high-technology industries. Although the Administration and lawmakers were careful to focus much of the increase in revenue on one-time expenditures, the reduction in capital gains and stock options from the stock market and the impact of national economic conditions resulted in a projected shortfall of \$3 billion in the current year and \$9 billion in the budget year. The shortfall in both the current year and budget year, combined with the need for a reserve, created a total budget gap of \$12.5 billion.

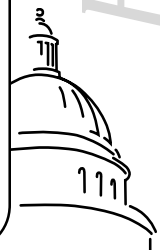
To address the changing economic and fiscal conditions facing the State in 2001, the Administration proposed significant spending reductions as part of the 2001-02 May Revision and, as actual receipts fell short of the May forecast, further reductions were identified collaboratively with the Legislature and through additional line-item vetoes of \$499 million in an effort to build a substantial reserve.

As revenues continued to fall short after enactment of the 2001-02 Budget, the Governor directed State departments to identify options for spending reductions ranging from three to fifteen percent. In addition, the Governor directed departments to freeze hiring and make current-year operating expense and equipment reductions totaling at least \$150 million. Finally, as noted below, the Administration identified nearly \$3 billion in spending reductions and transfers as part of an unprecedented "November Revision" to the Budget.

Including the November Revision reductions identified above, the Governor's 2002-03 Budget proposes a total of \$5.2 billion in expenditure reductions, \$586 million in funding shifts, and \$5.6 billion in loans, accelerations, and transfers to bridge the funding gap.

Without significant changes, the anticipated reduction in revenue combined with increased expenditures for K-12 education, tax relief, and health care would result in on-going expenditures outpacing annual revenues in the budget year and beyond. To address this imbalance, the Governor's 2002-03 Budget proposes reductions and other measures that will provide General Fund relief beyond the budget year.

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Amount
(Millions)**Major Reductions (\$5.226 billion)**

November Revision Reductions (Current and budget year impact)	\$2,449
Budget Year Reductions	2,677
Reserve for Litigation	100

Fund Shifts (\$586 million)

Shift to Lease-Revenue Bonds	160
Shift to General Obligation Bonds	7
Federal Special Education Grant	112
Shift per November Spending Revision	152
Shift to Other Special Funds	155

Federal Funding Increases (\$1.066 billion)

Medi-Cal offset (FMAP)	400
Child Support System Penalty Relief	181
Federal Funding for Health and Human Services Programs	50
Food Stamps for Post-August 22, 1996 Immigrants	35
Undocumented Felon Incarceration (SCAAP)	50
Security/Bioterrorism Funding	350

Loans/Accelerations/Transfers (\$5.624 billion)

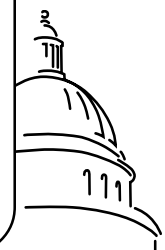
Securitize Tobacco Settlement Funds	2,400
Loan from Traffic Congestion Relief Fund	672
Current year transfers per November Spending Revision	366
Payment Deferral/Benefit Improvement for STRS	508
Payment Deferral/Benefit Improvement for PERS	371
Loans from Various Special Funds	579
Transfer of Excess Balance from Certain Special Funds	201
Federal Tax Conformity	178
Other Revenue Accelerations	349
Total	\$12,502



Major Expenditure Reductions

In addition to reductions proposed in the Governor's *Proposed Reductions in 2001-02 Spending* plan submitted in November 2001, the following reductions are proposed:

	Amount (Millions)
K through 12 Education The proposed reductions maintain spending at the Proposition 98 spending level and provide funding for full growth and cost-of-living adjustments.	\$487
Higher Education The proposed reductions will have minimal effects on the core instructional mission of the colleges and universities. The Budget provides full funding for enrollment increases and provides for no increase in student fees.	451
Health Programs The Budget maintains funding for children in the Healthy Families program and the recent expansion of health coverage for children, seniors, and the working poor.	407
Human Services Programs The proposed reductions limit overall spending growth while protecting critical human services for children, seniors, and the disabled.	742
Youth and Adult Correctional Programs The proposed reductions in corrections State operations are modest in order to ensure public safety.	17
Resources/Environment The Budget reductions reflect proposals to lower activity levels in several programs while maintaining funding for essential environmental monitoring.	35
Housing The Budget reduces funding for certain programs in anticipation of a housing bond, while maintaining funding for critical emergency and farmworker housing programs.	38
Local Government Minimal reductions are made in local government programs.	9
Capital Outlay Projects The Budget defers projects that can be delayed without adversely affecting programs or the economy.	92
Remaining Program Reductions The Budget proposes reductions in various other programs, particularly in State operations, where low priority activities are discontinued or reductions can be made without significantly affecting delivery of services.	399



Fund Shifts

The Governor's Budget includes a shift of funding source for various programs or projects, thereby freeing General Fund resources for other critical needs. Some examples are:

- ❖ **Capital Outlay**—a total of \$159.8 million to lease-revenue bonds. This includes \$135 million for University of California Research Institutes (\$40 million in 2001-02 [in addition to the shift proposed in November] and \$95 million in 2002-03); \$5.5 million for the Department of Justice Redding Laboratory and \$6.2 million for the Santa Rosa Laboratory; \$3.5 million for three Department of Forestry projects; and \$2.7 million for the Youth Authority Adjustment Center project.
- ❖ **Seismic Projects**—\$7 million to General Obligation Bonds for various seismic projects.
- ❖ **Department of Forestry**—\$20 million to local reimbursements for State Responsibility Area activities.
- ❖ **State Water Resources Control Board**—implementing the “polluter pays” principle for the Board’s core regulatory programs by replacing \$15 million General Fund with increased fee revenues in the Waste Discharge Permit Fund. This will increase the regulated community’s support of the core regulatory program from 34 percent to approximately 50 percent.
- ❖ **Department of Toxic Substances Control**—\$7.9 million to the Toxic Substances Control Account for cleaning up contaminated sites, overseeing toxic cleanups at military bases, and supporting related administrative costs.
- ❖ **Public Utilities Commission**—\$2.7 million to the Public Utilities Commission Utilities Reimbursement Account for electrical energy rate stability and conservation activities, pursuant to Chapter 329, Statutes of 1999.
- ❖ **Department of Corrections**—\$2 million for the Female Offender Treatment Program and \$10.6 million for the Preventing Parolee Crime Programs to be funded from federal Workforce Investment Act funding.
- ❖ **Department of Education**—\$112 million resulting from an increase in the Federal Special Education Grant. The State’s special education funding formula utilizes additional federal special education funds as an offset to the amount of General Fund required for the program. This statutory formula was suspended last year to provide additional funds to the program. This Budget proposes to use the federal funds as an offset consistent with the statutory formula.



Federal Funding Increases

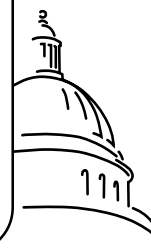
Health and Human Services Agency—The Budget proposes a \$666 million General Fund reduction in various health and human services programs. Of this amount, the Budget assumes that federal legislation will be enacted to provide California with an additional \$400 million in federal funds to offset the cost of Medi-Cal services. The Budget also assumes that California will receive a waiver of federal penalties imposed due to delayed implementation of a statewide automated child support system, for an estimated \$181.3 million in General Fund savings. In addition, the Budget anticipates \$50 million in savings by maximizing federal funds for individuals eligible for various health and social services programs. An anticipated expansion of the federal Food Stamp Program to cover California Food Assistance Program recipients is expected to result in net General Fund savings of \$35 million.

Department of Corrections—The Governor's Budget reflects an additional \$50 million for the State Criminal Alien Assistance Program to cover a greater share of the State's cost for the incarceration of undocumented felons. Even with this higher level of reimbursement, less than half of the State's costs will be recovered.

Security/Bioterrorism—An additional financial pressure facing California is the cost of the response to the increased threat of terrorist acts. Both State and local government security costs have increased and will likely continue to increase as threats become better known and responses are developed. As the new threat of international terrorism is an act of war, the Administration has requested that the federal government provide financial assistance for these costs. The Budget reflects the anticipated receipt of \$350 million from the federal government to offset current and prospective State and local government expenditures. The California Highway Patrol's (CHP) budget reflects \$129 million of these funds, offsetting costs that normally would have been borne by the CHP's usual funding source, the Motor Vehicle Account (MVA). The magnitude of such costs is far beyond the capacity of the MVA; absent federal funds, much of these costs would fall to the General Fund. See the Assuring Public Safety Section for more information about terrorism-related expenditures.

Loans and Accelerations

The Administration has carefully reviewed the opinions and economic forecasts of the business and academic community. Although predictions as to the timing of the economic recovery vary, the view of economists is that the California recession, unlike that of the early 1990s, will be of relatively short duration. Some economists predict recovery starting mid-next year; others predict a later start. But none predict an indefinite recession.



The fundamental task of this Budget is to protect the schools, environment, public safety, and health services for the citizens of this state. Accordingly, it makes sound economic sense to consider measures that avoid draconian budget reductions in essential services, while still taking appropriate steps to reduce growth in spending.

Securitization of Tobacco Settlement Funds—To prevent further reductions to valuable health care programs, the Budget proposes to issue a bond of \$2.4 billion secured by a portion of the Tobacco Settlement revenues received by the State. The bond proceeds will be used to help maintain the health safety net for the state's most vulnerable residents. The Tobacco Settlement securitization will operate similar to a lease-revenue bond, in which a revenue stream, in this case a portion Tobacco Settlement revenues, will be committed to service debt payments. Debt service for the securitization will require a payment of \$62 million in 2002-03, and annual payments of \$190 million for 22 years thereafter.

Loan from the Traffic Congestion Relief Fund—The Budget proposes to improve cash management in the State's transportation funds to facilitate a loan of \$672 million to the General Fund from General Fund money deposited into the TCRF in 2000-01. To extend the term of this loan into 2003-04, the Budget also includes a loan of \$474 million from the State Highway Account (SHA) fund balance to the TCRF in 2002-03. Of the SHA loan, \$360 million is made available by eliminating the need to carry a large SHA cash balance just to cover daily fluctuations in spending. This is accomplished by providing standby short-term borrowing authority for the SHA. The Administration will propose statutory provisions that require all loans to be paid back to the lending fund when needed to meet budgeted expenditures. Much of these loans will be repaid in 2003-04, and no projects will be delayed.

Defer Payment to the State Teachers Retirement System (STRS) and Provide an Enhanced Benefit—The Administration is proposing to defer General Fund contributions to STRS in exchange for providing an enhanced level of teacher retirement benefits. This deferral would not adversely affect teacher retirement benefits. In exchange for deferring the General Fund contribution to STRS, this proposal would increase contributions to STRS' Defined Benefit Supplement accounts (separate tax-deferred accounts). This proposal would result in reduced General Fund expenditures of approximately \$96.2 million in 2001-02, \$411.7 million in 2002-03, and \$440.5 million in 2003-04. Additional General Fund contributions in subsequent years would offset the temporary reduction in General Fund contributions to STRS' Defined Benefit Program.

Defer Payment to the Public Employees Retirement System (CalPERS) and Provide an Enhanced Benefit—The Budget reflects a proposal to defer a significant portion of the State's 2002-03 retirement obligation to CalPERS in exchange



for providing a higher level of purchasing power protection for State and school retirees. Based on the proposal, the State obligation will be reduced by \$537.2 million, of which \$495.2 million is attributable to State categories and \$42 million to the school category. The General Fund reduction for State categories will be \$371.4 million in 2002-03, and \$123.8 million will be realized in 2003-04 (as a result of the fourth quarter deferral).

The Administration has proposed the STRS and CalPERS actions because of the difficult economic conditions of the state. However, should the May Revision to the Budget show an improvement in the state's economic conditions, or if less-costly alternatives can be developed, such as refinancing the State's long-term debt in recognition of historically low interest rates, the Administration will reconsider these proposals.

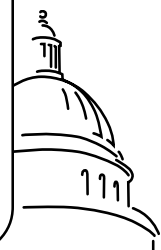
Transfers of Excess Fund Balances from Specific Funds—The Budget proposes the transfer of idle cash balances to the General Fund from various other funds, where the balances are not legally restricted.

The transfers from nineteen funds are reflected in the fund conditions in individual departmental budget displays. These proposed transfers total \$97 million. The funds and transfer amounts are as follows:

Fund	Amount (Millions)
State School Building Aid Fund	\$25.2
Colorado River Management Account	22.0
State Parks and Recreation Fund	19.8
Small Craft Harbor Improvement Fund	4.8
Health Statistics Special Fund	4.2
Other	21.0

Additionally, \$63 million of funds are proposed for transfer from various capital outlay funds. This includes \$49.6 million of unutilized lease-revenue bond funds that will offset debt service payments, and a sweep of the Architectural Revolving Fund and the Inmate Construction Revolving Account that yields \$13.9 million.

Loans from Various Special Funds—The Budget proposes loans totaling \$579 million from fifteen special funds to the General Fund. These loans will be repaid with interest at the rate earned by the Pooled Money Investment Account.



The Budget proposes language that requires all loans to be paid back to the lending fund when needed to meet budgeted expenditures. The funds and loans amounts are as follows:

Fund	Amount (Millions)
Beverage Container Recycling Fund	\$218.0
Renewable Resource Trust Fund	150.0
Vehicle Inspection and Repair Fund	70.0
Restitution Fund	20.0
State Corporations Fund	20.0
Pollution Control Financing Authority Fund	20.0
Tax Credit Allocation Fee Account	20.0
Occupancy Compliance Monitoring Account	20.0
Real Estate Commissioner's Fund	9.9
Barbering and Cosmetology Fund	7.0
Other	24.1

Federal Conformity—The federal Economic Growth and Tax Relief Reconciliation Act of 2001 made a number of significant changes, particularly in the tax treatment of retirement plans. The Budget proposes that State tax law conform with these retirement plan changes, as well as revisions in the treatment of qualified tuition plans and increases in the dependent care credit. In addition, this proposal would provide that any federal election for corporations applies for State tax purposes and would accelerate revenues by bringing California's rules for estimated payments in line with federal rules. Conformity in these areas will simplify tax compliance and administration. The combined conformity changes and accelerations will result in a net revenue gain of \$178 million in 2002-03 and revenue losses of \$59 million in 2003-04 and \$75 million in 2004-05.

